Office of Chief Counsel
Internal Revenue Service
memorandum
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date: 3/27/02

to: Pat Sturgis, Manager, CTM 1284
Attn: Kurt Branning

from: Office of Chief Counsel
LMSB (Natural Resources), Area 4, Phoenix

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subject: [redacted]
Characterization of instrument as equity

This memorandum responds to your request for assistance of March 21, 2002. This memorandum should not be cited as precedent.

ISSUE

Whether the taxpayer characterized (within the meaning of I.R.C. § 385(c)) a specific instrument to [redacted] as stock.

CONCLUSION

The taxpayer characterized this instrument as stock.

FACTS

In [redacted], the taxpayer's board of directors considered several proposals for subordinated debt and preferred stock in connection with its efforts to raise funds. The board accepted the proposal from [redacted], resulting in an agreement with [redacted] dated [redacted]. This agreement, titled "Securities Purchase Agreement," states that "[redacted] desires to purchase..., and the [taxpayer] desires to issue and sell to [redacted].. [redacted] shares of the [taxpayer's] Series A Senior Redeemable Preferred Stock... and [redacted] common stock purchase warrants... ." The agreement consistently and repeatedly references the transaction as involving the issuance and sale of stock by the taxpayer, and the purchase of stock by [redacted]. In connection with this transaction, the taxpayer amended its Certificate of Incorporation with the State of Delaware to reflect issuance of this stock, and the taxpayer gave [redacted] a stock certificate reflecting [redacted] shares of preferred stock.

As consideration, [redacted] paid the taxpayer $[redacted]. Pursuant to the agreement, the parties allocated $[redacted] to the preferred stock, and $[redacted] to the warrants. The agreement further provided that the preferred stock would pay a dividend of [redacted] percent. [redacted] obtained the right to elect one director to the taxpayer's board, and in the event of "default" on dividend payments, would have the right to elect a majority of the directors. Upon liquidation of the taxpayer, the preferred shares would have priority over other shareholders, but would be subordinate to creditors. After [redacted] years from the issuance date, the taxpayer must redeem its preferred shares for $[redacted] plus accrued but unpaid dividends. The agreement also requires the taxpayer to pay [redacted]'s closing costs.

During your examination of the taxpayer, you have discovered that the taxpayer has claimed interest deductions for dividends paid on this preferred stock. In discussing this matter with the taxpayer, you have been informed that the taxpayer believes that [redacted]'s shares of preferred stock represent debt rather than equity, and that the payments therefore constitute interest on such debt. You are presently unaware of [redacted]'s treatment of such amounts. You believe that I.R.C. § 385(c) allows the Service to bind an issuer of an instrument to its characterization of such instrument at the time of issuance. In that regard, you have requested our advice as to whether the taxpayer characterized this transaction as stock, so that its payments to the holder constitute dividends rather than interest.

DISCUSSION

Historically, the question of interest versus dividends has been one of fact, with the ultimate question being whether the investment at issue constitutes risk capital subject to the fortunes of corporate venture, or whether it instead reflects a debtor-creditor relationship. See, e.g., Donisi v. Commissioner, 405 F.2d 481, 482 (6th Cir. 1968); Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3rd Cir. 1968). In making such factual determinations, courts have formulated different tests to assist in making these determinations. See, e.g., Hardman v. United States, 827 F.2d 1409, 1411 (9th Cir. 1987), in which the court identified eleven factors which "to varying degrees, influence resolution of" the issue; Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972), in which the court listed thirteen factors "which merit consideration in determining this issue." As you know, these several tests often resulted in extremely contentious examinations, with parties reluctant to agree that specific factors might weigh in favor of the other party, and arguing vehemently that specific factors in their favor should be considered the most significant. In addition, the Service often found itself in a "whipsaw" position, risking exposure from two sides unless it examined and proposed adjustments to returns for both parties to a transaction.

It was against this background that Congress enacted I.R.C. § 385(c), effective for instruments issued after October 24, 1992. Under this section, the "characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest... ." I.R.C. § 385(c)(1). Although § 385(c)(2) allows a holder to opt out by providing notice of inconsistent treatment, there are no exceptions allowing an issuer to avoid the consequences of its characterization of an instrument.

In the present case, the taxpayer issued stock certificates. The stock certificates were issued pursuant to a securities purchase agreement. Although this memorandum does not discuss the lengthy agreement on a page-by-page basis, the agreement in no way suggests that the issuance might be debt, and makes an extremely large number of statements in its [redacted] pages and exhibits consistent with its labeling of the issuance as stock (for example, repeated reference to compliance with securities laws, dividends, capitalization, "other" shareholders, investment, authorized capital stock, issue price for purposes of Reg. § 1.305-5(b)). We believe that there is no question that at the time of issuance, the taxpayer clearly and unambiguously characterized the instrument at issue as stock. It is therefore appropriate to disallow the taxpayer's claimed deductions for dividends paid on account of such stock.

We nonetheless acknowledge the taxpayer's assertion that the lack of any regulations expounding on § 385(c) mandates the use of the above-referenced common-law tests to determine the taxpayer's characterization of the issuance. Frankly, we are puzzled by this position. Section 385(c)(1) appears clear and unambiguous on its face. As stated in <u>United States v. American Trucking Associations, Inc.</u>, 310 U.S. 534, 543 (1940), "There is no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning." If an issuer characterizes an instrument as stock or debt at the time of issuance, the absence of regulations should not prevent application of the statute's clear and unambiguous provisions, as nothing in the legislative history indicates that such regulations are required. Nothing prevents the application of a statute until the promulgation of regulations, even if, unlike § 385(c), the statute at issue is not clear on its face. The reasons for the taxpayer's dislike of § 385(c) are obvious, since application of the plain language of this statute results in disallowance of its claimed interest deduction for dividends paid. The taxpayer, however, can give no valid reason why this section should not apply to it.

The taxpayer also claims that a review of the characteristics of this issuance indicates that it constitutes debt rather than equity. For example, the taxpayer claims that it had valid reasons to prevent dilution of its stock, thereby indicating that it could not have intended the instrument to be preferred stock. Our response to this is twofold. First, § 385(c) is specifically intended to make such claims irrelevant. If the issuer chooses that it is in its best interests to characterize an instrument as stock, either in exchange for better terms or for other reasons, § 385(c) binds the issuer to that characterization. The claim that the taxpayer did not want to dilute its stock is irrelevant, since it chose to issue an instrument which it clearly characterized as stock.

Second, although we have not analyzed the taxpayer's claims in detail, it seems to us that many of its assertions in favor of the claimed "intent" to issue debt are rather tenuous and self-serving. In that regard, we encourage you to discuss the above-mentioned common-law factors as an alternative position. We nonetheless believe that your primary position must be the taxpayer's characterization of the instrument at the time of issuance as stock.

We also want to advise you that we have informally coordinated this matter with personnel in our national office, and have been advised of their agreement with us that one who issues preferred stock pursuant to a securities purchase agreement has in fact characterized the instrument as stock. We have provided this non-docketed significant advice rather than seeking field service advice due to national office agreement with us that, due to the clear language of § 385(c), the law in this area is sufficiently established so as to not require field service advice.

Please be advised that we consider the statements of law expressed in this memorandum to be significant large case advice.

We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow for appropriate national office post-review. If you have any questions regarding the above, please contact the undersigned at (602) 207-8052.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

JOHN W. DUNCAN
Attorney